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FACSIMILE MESSAGE COVER SHEET

DATE: March 23 1998

TO: David S Guzy

FIRM: Royalty Management Service
Minerals Management Service

FAX NUMBER: 303-231-3385

FROM: Ray Powell, Commissioner of Public Lands

SUBJECT/MESSAGE: Comments on Proposed MMS Rule

NUMBER OF PAGES THIS TRANSMISSION INCLUDING THIS COVER

6

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March 23, 1998

Mr. David S. Guzy, Chief
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Transmitted by FAX (303) 231-3385 and mail.

Subject: Comments on Supplementary Proposed MMS Rule on Valuation of Federal Royalty Oil; Notice Published February 6, 1998

Dear Mr. Guzy:

Enclosed are the New Mexico State Land Office (SLO) comments (4 pages) on the above supplementary proposed rule.

The SLO again commends the MMS for pursuing its new proposed valuation regulations for oil and remains in adamant support of discontinuation of posted prices to value federal royalty crude oil. We assure you that the New Mexico SLO is actively involved with the Oil Industry in pursuing past under-reported state crude oil royalties and in looking to future pricing methodologies.

In New Mexico, SLO works primarily for education through our various beneficiaries, and the state share of your federal royalty collections are dedicated to funding public education. Therefore, any increases in crude oil revenues which would result from revised oil valuation methodologies would directly benefit education funding in this state.

We understand that comments on this proposed rule can be made through March 23, 1998, and that we are not required to resubmit all our previous comments on prior versions of this proposed rule, but that they will be taken into account when you proceed to a final rulemaking. We may want to submit further comments after we have seen any redrafted rule.

Sincerely,

RAY POWELL, M.S., D.V.M.
COMMISSIONER OF PUBLIC LANDS

New Mexico State Land Office (SLO)
Comments on Supplementary Proposed MMS Rule on Valuation
Of Federal Royalty Oil, 30 CFR Part 206, Notice Published February 6, 1998

The New Mexico SLO hereby comments on the Supplementary Proposed MMS Rule, which would modify the valuation procedures for both arm's-length and non arm's-length federal royalty crude oil transactions, proposes separate valuation procedures for geographic regions (California/Alaska, the Rock Mountain Area, and the "rest of the country" which includes New Mexico), and in regard to non arm's-length transactions in the "rest of country" region proposes valuation based on the average of the daily mean "market center" spot prices with adjustments for applicable location and quality differentials and transportation costs.

SLO comments prepared March 23, 1998

I. – General Comments

SLO again commends the MMS for pursuing its new proposed valuation regulations for oil and remains in adamant support of discontinuation of posted prices to value federal royalty crude oil. We support use of appropriate index pricing for valuation in non arm's-length situations, and agree that differentials for quality and location adjustments must be made for federal royalty crude oil to arrive at an accurate lease value.

We recognize that MMS is responding to other commentors by developing proposed separate valuation procedures for three geographic regions, and that you are specifically requesting input on your proposal that New Mexico be included in the "rest of the country" area rather than in the "Rocky Mountain Area." **SLO supports the exclusion of New Mexico from the Rocky Mountain Area and its inclusion in the "rest of the country" area as it pertains to your proposed separate valuation methodologies.**

However, we are unsatisfied and unconvinced by your decision to move away from your previous proposal to adopt index pricing using the average of the daily NYMEX futures settle prices for the Domestic Sweet Crude Oil Contract for the prompt month, for federal leases outside of California (in what would now be the "rest of the country" area).

In regard to valuation using the gross proceeds method for sales under an "arm's-length" contract [Section 206.102], SLO is concerned with possible diminished valuation resulting from overall balancing agreements, and with what appears to be an increased burden on the MMS to demonstrate that a particular balancing agreement may invalidate the arm's-length nature of a contract.

SLO appreciates the expansion of the definition of "exchange agreements" to no longer exclude agreements whose principal purpose is transportation. However, given our previously stated concerns with overall balancing agreements, we suggest that consideration be given to definition or other specification to strengthen MMS's ability to invalidate the arm's-length nature of a contract.

II. – Exclude New Mexico from the definition of the Rocky Mountain Area

SLO supports the MMS decision to exclude New Mexico from the "Rocky Mountain Area" which MMS defines to include the States of Colorado, Montana, North Dakota, South Dakota, Utah and Wyoming.

We recognize that MMS is responding to other commentors who argue for different valuation procedures for the Rocky Mountain Area because they observe that the Rocky Mountain Area exhibits that: "Production is controlled by relatively few companies"; "The number of buyers is also more limited than in the Texas, Gulf Coast, or Mid-continent areas and there are limited third party shippers and less competition for transportation services"; and "there is less spot market activity and trading in this area as a result of control over production and refining and because crude oil production is smaller and more diffuse than in the Gulf Coast and Permian Basin areas." [Quotes are from the Federal Register of 2/6/98, page 6115.]

Taken as a whole, those descriptions certainly do not apply to New Mexico, as our major oil production is from the Permian Basin in SE New Mexico. In regard to the lesser production from the San Juan Basin in NW New Mexico, our information and research tends to show that production from this basin is often connected to the Midland, Texas or Cushing, Oklahoma market centers through buy/sell arrangements of major producers.

Finally, respectfully, the SLO is unattracted to and unconvinced by the efficacy of the complex, proposed four-tiered hierarchy of valuation methods for the Rocky Mountain Area, beginning with an "MMS-approved tendering program" [found in Section 206.103(b)]. The SLO is strongly opposed to including the San Juan Basin in New Mexico as part of the "Rocky Mountain Area" for purposes of valuation under these proposed regulations.

III. – Valuation of Non Arm's-Length Transactions in "Rest Of The Country" Area

With the reservations noted in the following paragraph, the New Mexico SLO recognizes and supports the "average of the daily mean spot prices" methodology [found in Section 206.103(c)] as an improvement over the historic use of "posted prices" which are the result of decisions made by individual oil companies with no public accounting as to how they are determined.

However, we are concerned with the potential for manipulation of (diminishment of) spot price estimates based on daily phone surveys after the proposed MMS methodology is put in place and industry buyers and sellers perhaps change their behavior. In Section 206.104(a)(3), MMS indicates it will use as one criterion for selection of acceptable index price publications: "Publications that use adequate survey techniques, including development of spot price estimates based on daily surveys of buyers and sellers ..." We agree with the emphasis on adequate survey techniques, and are concerned that what may have been adequate in the past may become inadequate once this methodology is put in place. **In general, these concerns lead us back to our support for use of the NYMEX price as a valid indicator of the market price of U.S. crude oil outside of California.**

In your request for comments on this new, supplementary proposed rule, MMS indicates that commentors need not repeat all of their past comments, and we will not do so. However, we do repeat some salient points in support of NYMEX based indexing:

** **NYMEX crude transactions constitute a huge volume of crude oil in a market that is public and has a very large number of oil company participants. Millions of barrels are bought and sold each business day and the number traded on NYMEX is substantial to the total world production of crude oil.**

** **The NYMEX price is established by trading in an open market, which cannot be controlled by any one oil company or small group of companies. The closing price on the NYMEX reflects a fair market value since it represents consensus of a large number of willing buyers and sellers regarding the value of a standard quality of crude oil at a given point in time at a specified location.**

In short, SLO urges the MMS to reconsider regulated use of NYMEX indexing, with appropriate adjustments, as part of the methodology for valuation of non arm's-length crude oil transactions, by modifying the proposed regulation for the "rest of the country" [at Section 206.103(c)].

SLO respectfully points to one of MMS's arguments for moving away from NYMEX toward spot prices as a valid argument for retaining the use of NYMEX in the face of potential spot price manipulation [quoted from the Federal Register of 2/6/98, page 6116]:

> "MMS chose spot prices over NYMEX because studies indicated that when the NYMEX futures price, properly adjusted for location and quality differences, is compared to spot prices, it nearly duplicates those spot prices."

IV. – Need to Protect Gross Proceeds Methodology from Potential Impacts of Overall Balancing Agreements

As mentioned in our General Comments, the SLO is concerned with possible reduced valuations using the gross proceeds methodology for sales under "arm's-length" contracts when there also exists overall balancing agreements. Previous versions of the proposed valuation regulations precluded the gross proceeds methodology when a company sold crude to another company with which it had an overall balancing agreement -- an agreement in which two companies agree that they will keep the volumes sold to one another equal. It may be argued that when two companies have entered into an overall balance agreement, they become indifferent as to the dollar amount placed on the barrels of comparable crudes being sold to one another, leading to potential diminishment of reported values.for royalty purposes.

We recognize that MMS indicates in these revised proposed regulations that it will consider whether a contract is arm's-length and if an overall balance agreement is found then this will invalidate the arm's-length nature of the contract. However, it appears that MMS has placed an increased burden on itself to determine whether a contract is subject to an overall balance agreement; this will be difficult to prove and would stretch the necessary focus of MMS audit activities.

We suggest that consideration be given to definition or other specifications to strengthen MMS's ability to invalidate the arm's-length nature of a contract in cases where an overall balance agreement exists between two companies.